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Supreme Court, U. S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1972.

No. 72-235

KEITH B. McKY,

Petitioner,

vs.

OLGA HOCHFELDER, et al.,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

The petitioner, Keith B. McKy, respectfully prays that a Writ of Certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Seventh Circuit entered on April 12, 1972.

OPINIONS BELOW.

The opinion of the United States Court of Appeals for the Seventh Circuit, which has not yet been reported, is reproduced in full text in the Appendix hereto. (pp. A23 to A33). The opinion of the United States District Court for the Northern District of Illinois, which was not reported, is reproduced in full text in the Appendix hereto (pp. A15 to A22) as is the Report of the court-appointed Special Master (pp. A1 to A14) which was confirmed in the opinion of the District Court.

JURISDICTION.

The judgment of the United States Court of Appeals for the Seventh Circuit was entered on April 12, 1972. A timely petition for rehearing *en banc* was denied on May 31, 1972 (p. A35) and this petition for a writ of certiorari was filed within ninety (90) days of that date. This Court's jurisdiction is invoked under 28 U. S. C. § 1254(1).

QUESTIONS PRESENTED.

1. Should a United States Court of Appeals adjudicate a question clearly controlled by Illinois law by relying exclusively upon a California case which is in direct conflict with all the applicable Illinois cases?

2. Should a conflict between the United States Court of Appeals for the Seventh Circuit and the United States Court of Appeals for the Ninth Circuit concerning the construction of Section 20(a) of the Securities Exchange Act of 1934 go unresolved?

STATUTE INVOLVED.

The statute involved herein is Section 20(a) of the Securities Exchange Act of 1934, 15 U. S. C. § 78t(a), as amended. This statutory provision is reproduced in full text in the Appendix. (p. A36.)

STATEMENT OF THE CASE.

The petitioner herein is the court-appointed Receiver of the property and assets of First Securities Company of Chicago ("First Securities"). Respondents Olga Hochfelder, Theresa W. Rothermel, Agnes Smith, Eugene Voita, Helen B. Feldkamp, Anna L. Jesse, William P. Jesse, Eric

W. Stubbs, Lurena T. Stubbs, Helen C. Allison, Leon N. Carnovsky, Zerah A. Drake, John M. Jackson, individually and as Trustee, and Elizabeth B. Jackson are persons who have asserted claims against the property and assets of First Securities. The Securities Exchange Commission (the "Commission") and the Customer Creditors Committee of First Securities are parties to the proceedings below but are not seeking review of the judgment and opinion below.

Nature of the Case.

On June 4, 1968, Leston B. Nay, President of First Securities, was found dead under circumstances indicating suicide; a suicide note was found indicating that there were improprieties in the handling of the accounts of certain of Nay's customers (Resp. Ex. 1).

At the time of Nay's death, First Securities was engaged in a stock brokerage business; it was registered with the Commission as a broker-dealer in securities and was a member of the Midwest Stock Exchange and the National Association of Securities Dealers, Inc.

Nay's suicide note indicated that he had been misappropriating funds belonging to the respondents for many years. An investigation was immediately commenced by the Commission. Based upon the findings of its investigatory staff, the Commission began this proceeding on June 10, 1968. In its complaint the Commission sought injunctive relief against First Securities and the appointment of a Receiver. The action was brought under Section 27 of the Securities Exchange Act of 1934, as amended, 15 U. S. C. § 77v(a). In its complaint, the Commission alleged that there had been violations of both Section 10(b) of the Securities Exchange Act of 1934, 15 U. S. C. § 78j(b), as amended, and Section 17(a) of the Securities

Act of 1933, 15 U. S. C. § 77a(a), as amended. A preliminary injunction was entered enjoining First Securities from the transaction of any further business; at a later date, the injunction was made permanent. On June 17, 1968, on the motion of the Commission, the petitioner was appointed Receiver of First Securities.

On July 26, 1968, an order was entered, fixing the time and prescribing the form and manner of filing proofs of claim. Subsequent to the filing of the proofs of claim, the petitioner, a certified public accountant, carefully reviewed each and every proof of claim and the accounting records and customer ledger sheets of First Securities. The respondents had filed claims based on their participation in a so-called escrow scheme which had been carried on solely by the late Leston B. Nay as his personal venture; they elected to initiate hearings on their claims when advised that the petitioner would not recommend that their claims be allowed.

In November of 1968, hearings were held on the claims of the respondents before Charles A. Bane, Esq., the Special Master appointed by District Judge Julius J. Hoffman. Although the claims of the fifteen (15) respondents were not identical in nature, they were treated as a single class of claims for purposes of the hearings and the evidence adduced was deemed applicable to all claims. (Tr. 86-7.)

On November 24, 1970, the Special Master filed his Report on the claims of the respondents with Judge Hoffman and recommended therein that all of the claims be disallowed. (pp. A1 to A14.) The petitioner moved on November 24, 1970, to confirm the Report of the Special Master and on December 22, 1970, Judge Hoffman delivered an opinion from the bench approving the Special Master's Report (pp. A15 to A22) and entered an order disallowing the claims of the respondents.

The respondents appealed to the United States Court of Appeals for the Seventh Circuit which reversed the judgment of the District Court. (pp. A23 to A33.)

The Facts.

The claims asserted by the respondents were based upon their participation in a spurious "escrow" scheme. Nay represented to the respondents that the "escrow" was a pool of interest-bearing deposits each of which could be redeemed either in whole or in part, within a stipulated number of days after service of appropriate notice upon Nay. The so-called "escrow" was devised and carried out by Nay without the knowledge or concurrence of any other officer, director or employee of First Securities. (Tr. 679, 713, 733, 741-3.) The escrow transactions never appeared on the accounting records and customer ledger sheets of First Securities (Tr. 733-6) and were never discovered by any of the regulatory agencies which made periodic surprise audits of First Securities. In essence, the escrow transactions were conducted solely by Nay out of a filing cabinet, small office safe and desk to which only he had access. (Tr. 708-710, 738-40, 742, 748.) Nay further secreted his escrow transactions with the respondents by insisting upon adherence to a rule that all mail addressed to him was to be opened by him and no one else. (Tr. 708, 737-8.)

The petitioner refused to recognize the claims of the respondents because the facts relating thereto plainly indicated that the escrow scheme was a private arrangement between Nay and the respondents in which Nay acted solely in his own behalf. The respondents clearly understood that the escrow transactions were divorced from the business conducted by First Securities and agreed in writing to look solely to Nay for satisfaction of their

claims. (Pet. Exs. 30, 65, 66, 76, 87, 127, 128, 129, 167, 168, 181, 196, 197, 198, 205.)

When the respondents purported to put funds into the escrow, they made their checks payable to Nay personally (or in a few instances to a bank for his personal account). (Tr. 97, 100, 101, 119-20, 216, 243, 395-7, 420-1, 474, 520-1, 529, 578, 604, 641; Drake Stip. Par. 3, Cross-exam.; Feldkamp Stip. p. 17; Carnovsky Exs. 1, 6, 9, 17, 20, 22; Allison Exs. 11 through 17; Jackson Exs. 2, 5, 8, 11, 13, 17, 19, 21, 21A, 24, 26, 28, 30; Rothermel Group Ex. 10; Pet. Exs. 78, 80, 199.) The checks were endorsed by Nay individually for deposit in his personal bank account and when cancelled, were returned to the respondents in the ordinary course of banking practice. (Tr. 396-7 and respondents' exhibits cited immediately above.)

All funds withdrawn from the escrow were remitted to the respondents by Nay's personal checks. (Tr. 107-9, 642; Drake Stip. Par. 15, Cross-exam.; Drake Ex. 21; Pet. Ex. 157.)

All moneys designated as interest on the escrow funds were paid to the respondents by Nay's personal checks drawn on his personal bank account. (Tr. 32-3, 68-9, 121, 203-4, 250, 267, 394-5, 469-70, 525, 539-41, 578, 584-5, 638-9; Drake Stip. Par. 1, 17, Cross-exam.; Feldkamp Stip. p. 17; Pet. Group Exs. 300, 301, 302, 304, 305, 306, 307, 308, 309; Pet. Exs. 303, 310.)

The respondents regularly received from Nay on an annual basis Treasury Forms 1099 showing the amount of interest paid to them by Nay during the preceding calendar year. The transmittal of these forms by Nay indicated that he was claiming a deduction for such payments on his personal federal income tax returns. (Tr. 41-2, 69-70, 127-8, 207-8, 270-1, 380-2, 458, 472-3, 506-7, 543, 639-41; Drake Stip. Par. 2, Cross-exam.; Feldkamp Stip. p. 17; Pet. Exs. 207 through 221; Pet. Exs. 104, 177.)

Nay's personal federal income tax returns for the years 1956 and 1965 were audited by the Internal Revenue Service. In connection with each of those audits, Nay wrote to the respondents advising them that his tax return was being examined and asking that they verify the amount of his indebtedness to them and the amount of the interest he had paid them during the year under review. These letters, all of which were accepted as correct by the respondents and signed by them and returned to Nay to indicate their concurrence in the statements contained therein, explicitly show that the funds delivered by the respondents to Nay for the so-called escrow gave rise to a personal indebtedness on his part and that the obligation to repay the loan and to pay the interest was his individually. (Smith Ex. 5; Pet. Ex. 181; Hochfelder Ex. 4; Pet. Ex. 87; Voita Ex. 2; Pet. Ex. 205; Pet. Ex. 30; Jackson Exs. 67, 68; Pet. Ex. 102; Stubbs Ex. 7; Pet. Exs. 196, 197, 198; Jesse Ex. 4; Pet. Exs. 127, 128, 129; Rothermel Ex. 4; Pet. Exs. 167, 168; Pet. Exs. 65, 66; Feldkamp Ex. 30; Pet. Ex. 76.)

The respondents reported the interest received from Nay as income on their own tax returns and showed Nay as the payor of the interest. (Tr. 17-18, 36, 74, 129, 206, 251, 270, 381, 427, 473-4, 543-4, 578-9, 608-9; Drake Stip. Par. 2, Cross-exam.; Feldkamp Stip. pp. 5, 17; Feldkamp Ex. 6.)

Nay's personal checking account and his income tax returns, which contained information relating to the escrow, were handled by him exclusively and kept under lock and key. (Tr. 710-1, 736-7, 740-1.)

Nay's agreements with the respondents frequently contained the express provision that "This agreement is binding and inures to the benefit of your and my heirs, executors and assigns". This, of course, is language customarily used to evidence a personal as distinguished from a corporate obligation. (Pet. Exs. 78, 79; Carnovsky Ex. 2; Stubbs Ex.

6; Anna Jesse Ex. 3; Rothermel Ex. 3; Pet. Exs. 145, 146, 161; Drake Exs. 1, 3; Feldkamp Exs. 14, 15; Pet. Ex. 74.) Each of the confirmation letters sent out by Nay to the respondents respecting the audit of his federal income tax returns contained the statement that "the indebtedness is binding upon my heirs, executor and assigns". (Pet. Exs. 30, 65; Feldkamp Ex. 30; Pet. Ex. 87; Jackson Ex. 68; Anna Jesse Ex. 4; Pet. Exs. 128, 129, 168; Smith Ex. 5; Pet. Exs. 197, 198; Voita Ex. 2.)

The fact that the respondents knew that they were dealing with Nay as an individual is manifested by their inquiries to him as to how they should proceed in the event of his death. In his responses to these inquiries Nay told the respondents that they would be taken care of by the Continental Illinois National Bank and Trust Company of Chicago, where the escrow was maintained, or by his wife or his lawyer. (Tr. 65, 133, 384-6, 538, 569, 585, 610-11.) Other respondents were advised by Nay that since the funds were in escrow the participants would be paid off "independently of the probating of my estate". (Pet. Ex. 177; Carnovsky Ex. 25.) Thus Nay's answers never involved First Securities and directed the attention of the respondents to the personal character of his obligations to them.

The respondents reposed trust and confidence in Nay individually since he was named as executor or successor executor in their wills. (Tr. 40, 156-7, 253, 272, 559, 581-2.) It was the personal relationship between the respondents and Nay individually that induced them to give him their funds for the escrow. Thus, a number of escrow advances were made by the respondents as a personal favor to Nay so that he could help friends of his. (Tr. 61, 63-4, 185, 480, 547-55; Pet. Ex. 193.) Nay's handling of the escrow in his own behalf as an individual is shown by his repeated refer-

ences to the fact that he and members of his family were participants and that he was permitting only a few close friends to come in with him. (Tr. 12-13, 96, 157, 214, 243, 379, 464-5, 537, 569, 600-2; Drake Stip. p. 2, Par. 5, Cross-exam.; Feldkamp Stip. p. 4.)

Nay at no time told the respondents that First Securities had anything to do with the escrow or that it had any interest or participation therein or that he was acting in behalf of First Securities in obtaining funds for the escrow. (Tr. 44-5, 254-5, 309-10, 425, 481, 538-9, 577, 602, 643-4; Drake Stip. Par. 5, Cross-exam.; Feldkamp Stip. p. 18.)

Those features of the escrow which should have provoked suspicion were the atmosphere of secrecy in which the matter was discussed and the unusually high rate of interest offered to the respondents on their funds. Nay told the respondents not to talk about the escrow and to keep it very quiet and that he could not divulge the name of the loan company involved. (Tr. 59, 95, 273, 308-9; 373-4, 393, 426, 428-9, 476-7, 545-6, 601-2; Feldkamp Stip. pp. 12, 16, 18; Drake Stip. Par. 5, Cross-exam.) The initial rates of interest promised to the respondents by Nay were either 12% or 9% per annum and in one instance the initial rate was as high as 4% per month. (Tr. 12, 58, 96, 157, 214, 244, 247, 310-11, 393, 448, 517, 560, 600, 644; Drake Stip. Par. 8, Cross-exam.; Feldkamp Stip. pp. 4, 12, 16.)

Although the respondents had been told that the escrow account was maintained at the Continental Illinois National Bank and Trust Company of Chicago (Tr. 65, 95, 312, 538, 585-6, 601; Drake Stip. p. 2), they made no inquiries there to verify its existence. (Tr. 115, 143, 401-2, 426, 644; Drake Stip. Par. 7, Cross-exam.) Nor did they exercise due diligence with respect to their right to withdraw their escrow deposits. Some of the respondents made no requests whatsoever for withdrawal. (Tr. 22-4, 271, 398, 425-6, 579;

Feldkamp Stip. p. 19.) Others, having received the return of some of their funds, made no request for withdrawal of the balance. (Tr. 107-8, 120-1; Drake Stip. Par. 6, Cross-exam.) Although some respondents did request withdrawals, they took no steps to enforce their requests even when Nay was obviously stalling them. (Tr. 208-9, 456, 479-80, 547, 549-50, 632-5; Carnovsky Exs. 26, 27, 29.)

During the last several years prior to Nay's death his interest payments to the respondents became irregular and delinquent, and although this was a matter of concern to them, they did nothing about it. (Tr. 81, 125-6, 215, 267, 369, 470-2, 541-3, 606-7, 565; Drake Stip. Par. 6, Cross-exam.; Feldkamp Stip. pp. 13, 14, 15.)

The security transactions engaged in by the respondents with First Securities were carried out in a far different manner than the manner in which the escrow transactions were handled. This fact further emphasizes that the escrow transactions were considered personal in nature by both Nay and the respondents.

Whenever the respondents paid for stocks they purchased through First Securities, they made their checks payable to the order of First Securities, not to Nay. (Tr. 123, 269-70, 398, 478-9, 544, 642; Feldkamp Stip. p. 20.)

Whenever the respondents had money coming for stocks they sold through First Securities, they received checks issued by First Securities, not Nay's personal checks. (Tr. 68, 119, 205, 397-8, 519-20, 529, 577-8, 642; Feldkamp Stip. p. 20.)

Whenever the respondents delivered securities or funds to First Securities in connection with their security transactions, they received regular, printed receipt forms expressly signed on behalf of First Securities. (Tr. 72, 75, 124, 204-5, 257-8, 389, 533, 641-3; Feldkamp Stip. p. 20; Feldkamp Ex. 2; Jackson Exs. 32.01, 35; Stubbs Exs. 2, 3; Anna Jesse

Ex. 1; Rothermel Ex. 1.) The respondents dealt with personnel of First Securities other than Nay in connection with their security transactions, but only with Nay with respect to the escrow. (Tr. 72-3, 75, 273-4, 301-2, 362-5, 425, 472, 546, 642-3.)

Those respondents who received statements of their accounts with First Securities noted that the statements did not include the escrow funds or the interest payments thereon. (Tr. 386-7, 645; Jackson Exs. 36.54-36.66; Allison Ex. 3.)

Although all customer transactions were regularly recorded on the books of First Securities, the escrow transactions were not. (Tr. 733-6.)

The fact that the respondents were not relying upon First Securities in their escrow dealings with Nay is further confirmed by the evidence that they never requested a financial statement from First Securities and had no information concerning its financial condition. (Tr. 39, 407, 490, 544-5, 644-5; Drake Stip. Par. 7, Cross-exam; Feldkamp Stip. p. 19.)

First Securities was an Illinois corporation with its only offices being in Chicago and Champaign, Illinois. All banking and accounting and correspondence pertaining to the escrow was handled by Nay in Chicago. The respondents generally became acquainted with Nay and made deposits into the escrow while residing in Chicago or one of the suburbs of Chicago. (Tr. 83, 151, 232-3, 286, 460-1, 498-9, 525, 591, 651, 653.)

REASONS FOR GRANTING THE WRIT.

1. A United States Court of Appeals Should Not Be Permitted to Adjudicate an Issue of Substantive State Law by Disregarding All Local Decisions and by Relying Upon an Isolated Foreign Decision in Direct Conflict with Such Local Decisions Since This Is in Violation of Erie R. Co. v. Tompkins and Amounts to the Substitution of Federal Common Law for the Governing State Law.

Although the proceeding in the District Court was commenced by the Commission in reliance upon federal securities legislation, the question of whether or not the claims of the respondents should be recognized was adjudicated, in the first instance, by reference to the common law of agency rather than any federal statute.

The Court of Appeals reversed the District Court and held that Nay had acted as the common law agent of First Securities. However, the Court of Appeals adjudicated this agency question, which is clearly governed by Illinois law, by reference to a California decision which was obviously inconsistent with all the applicable Illinois cases. In this respect, the Court of Appeals utterly disregarded the rule of *Erie R. Co.* v. *Tompkins,* 304 U. S. 64 (1938) and the numerous cases which have expounded upon the *Erie* doctrine. The Court of Appeals, in substance, enunciated a federal common law of agency notwithstanding the clear mandate of *Erie* v. *Tompkins* to the contrary.

Because the respondents entered into the escrow transactions with Nay in Illinois and Nay performed all details of the so-called escrow in Illinois, Illinois law governed the determination of the agency question. Neither the Special Master nor the District Court ever considered the possibility that the law of any state other than Illinois could be

deemed controlling on the common law agency issue. But the Court of Appeals utterly disregarded the decisional law of Illinois and relied exclusively upon a California decision which cannot be reconciled with the applicable Illinois cases.

In so doing, the Court of Appeals violated the fundamental precepts of *Erie* v. *Tompkins, supra,* and other decisions of this Court which hold that a federal court, when faced with a question of purely local law, must ascertain and apply the governing local law rather than fashion its own version of what it believes the law ought to be.

In *West* v. *American Telephone and Telegraph Co.,* 311 U. S. 223, 237 (1940), this Court referred to the *Erie* doctrine and admonished a lower federal court for failure to ascertain and apply local rules of decision to a matter of substantive local law saying:

> "State law is to be applied in the federal as well as the state courts and it is the duty of the former in every case to ascertain from all the available data what the state law is and apply it rather than to prescribe a different rule, however superior it may appear from the viewpoint of 'general law' and however much the state rule may have departed from prior decisions of the federal court."

The foregoing was again reiterated by this Court in *Klaxon Company* v. *Stentor Electric Manufacturing Company, Inc.,* 313 U. S. 487 (1941), a diversity of citizenship case in which this Court held that the *Erie* doctrine required a Delaware federal court to apply state law, noting at 313 U. S. 497:

> "... the proper function of the Delaware federal court is to ascertain what the state law is, not what it ought to be."

Indeed, in the instant case the Seventh Circuit not only failed to adhere to the foregoing decisions of this Court, it

also overlooked its own opinion in *Hartzler* v. *Chesapeake and Ohio Railway Company*, 433 F. 2d 104 (7th Cir. 1970). In the *Hartzler* case the Seventh Circuit discussed its obligation under *Erie* v. *Tompkins, supra,* and *West* v. *American Telephone and Telegraph Co., supra,* saying at 433 F. 2d 107:

> "The responsibility of the federal courts, in matters of local law, is not to formulate the legal mind of the state but merely to ascertain and apply it."

The Seventh Circuit relied upon *Blackburn* v. *Witter,* 201 Cal. App. 2d 418, 19 Cal. Rptr. 842 (1962) in concluding that Nay acted as the common law agent of First Securities with respect to the escrow transactions. *Blackburn* v. *Witter,* a decision of the intermediate appellate court in California, is obviously of no assistance in ascertaining the law of Illinois. Moreover, *Blackburn* v. *Witter* was decided by reference to a provision of the California Civil Code (Calif. Civil Code § 2317) rather than as a matter of general agency law.

However, the most pernicious error which the Court of Appeals committed in relying upon *Blackburn* v. *Witter* was the fact that *Blackburn* v. *Witter* does not follow the Illinois cases which enumerate those elements which must be present to sustain a finding that an agent has been clothed with apparent authority.

In Illinois, in order for apparent authority to be created, (i) the agent must be purporting to act for his principal, and (ii) the third person must reasonably believe that the agent has authority to act on behalf of the principal. *Lawcock* v. *United States Trotting Association,* 55 Ill. App. 2d 211, 204 N. E. 2d 802 (1965); *Wing* v. *Lederer,* 77 Ill. App. 2d 413, 222 N. E. 2d 535 (1966).

The opinion in *Blackburn* v. *Witter* does not even mention the reasonableness of the third party's belief that the

agent has been authorized to act as a prerequisite to a finding that the agent had apparent authority. By mistakenly relying upon *Blackburn* v. *Witter,* the Court of Appeals failed to recognize and apply the rule of Illinois law that *a party seeking to establish that an agent has apparent authority must prove that he reasonably believed that the agent had authority to act on behalf of the purported principal.*

Lawcock v. *United States Trotting Association, supra,* and *Wing* v. *Lederer, supra,* expressly state that a *reasonable* belief by the third party that the agent has been granted authority to act is essential to a finding that apparent authority has been created. The long-standing Illinois rule is that the test of the reasonableness of a third person's belief that an agent has authority to act in a given transaction is whether, from the point of view of the third person, the transaction appears *regular on its face.* For example, in *Sinclair Refining Co.* v. *W. J. Newman Co.,* 224 Ill. App. 401 (1922), it was held that where a transaction is carried out in a mysterious, secret and confidential manner, a special duty of inquiry is imposed upon the person who deals with the purported agent. Thus, in Illinois, where an agent engages in a transaction which is a substantial departure from his normal course of conduct, a duty of inquiry arises. If this duty of inquiry is not satisfied, the party seeking to charge a purported principal for the acts of his purported agent cannot contend that the agent was clothed with apparent authority to act.

In the instant case the respondents could not have reasonably believed Nay had authority from First Securities because the escrow transactions were so extraordinary in nature and were such a noticeable departure from the way in which Nay customarily transacted business on behalf of First Securities.

Because the Seventh Circuit has elected to disregard the applicable Illinois cases and to rely instead upon a California case which is inconsistent with all Illinois decisions, it has evinced an utter disdain for the *Erie* doctrine and proceeded to fashion its own federal common law of agency. If *Erie* v. *Tompkins, supra, West* v. *American Telephone and Telegraph Co., supra,* and *Klaxon* v. *Stentor, supra,* are to retain their vitality and the federal courts are to be reminded of their obligation to ascertain and apply governing state law on issues of state law, this Court should grant certiorari to review the judgment of the Seventh Circuit.

2. This Court Should Resolve the Conflict Between the Seventh Circuit and the Ninth Circuit Concerning the Proper Construction of Section 20(a) of the Securities Exchange Act of 1934 Since This Conflict Creates a Significant and Recurring Problem in Litigation Arising Under the Federal Securities Acts.

The alternative basis upon which the Court of Appeals chose to impose liability upon First Securities for Nay's defalcations was Section 20(a) of the Securities Exchange Act of 1934. Notwithstanding the uncontroverted evidence in the record that no one at First Securities other than Nay was involved in the escrow transactions or, indeed, had even heard of the so-called "escrow", the Court of Appeals held that First Securities had not acted in good faith and could not avail itself of the exculpatory language of Section 20(a).

Thus, by its opinion the Seventh Circuit has held that vicarious liability may be imposed upon First Securities under Section 20(a) even though there was no evidence that anyone other than Nay was involved in the escrow and despite the fact that there was no possible basis for anyone at First Securities to believe that such a scheme was being conducted. Such a holding, if allowed to go unchal-

lenged, will emasculate the exculpatory proviso of Section 20(a) and will convert Section 20(a) into a statute of strict liability.

Moreover, the Seventh Circuit's opinion is in direct conflict with the Ninth Circuit's opinion in *Kamen & Co.* v. *Paul H. Aschkar & Company*, 382 F. 2d 689 (9th Cir. 1967), *cert. granted*, 390 U. S. 942 (1968), *cert. dismissed*, 393 U. S. 801 (1968). *Kamen* v. *Aschkar* arose out of the fraudulent sale of securities by agents of a stock brokerage firm and dealt with the same issue of Securities Exchange Act liability which is involved in this proceeding.

In *Kamen* v. *Aschkar*, agents of a stock brokerage firm had used the offices and facilities of the firm to carry out a fraudulent scheme wherein securities were sold with a representation that a profit was guaranteed on the resale. However, none of the remaining personnel of the firm was in any way involved in, or had any knowledge of, the fraudulent activities. The Ninth Circuit expressly held that where a controlling person neither participates in fraudulent activities nor has any reasonable grounds for believing such activities are taking place, there can be no liability under Section 20(a) of the 1934 Act. (382 F. 2d 697.) This is in direct conflict with the opinion of the Seventh Circuit in this proceeding.

The Court's attention is directed to the fact that when the Securities Act of 1933 was still in Committee, the Senate version called for an insurer's or absolute liability for controlling parties, whereas the House version afforded a controlling person the opportunity to exonerate himself from liability upon a showing that he could not reasonably have been expected to know of the wrongdoing of the controlled party. H. R. Rep. No. 152, 73d Cong. 1st Sess. 26 (1933). The ultimate acceptance of the House version left no doubt that Congress intended to alleviate controlling

parties from a strict application of respondeat superior. The decision of the Seventh Circuit thwarts the intent of Congress in promulgating Section 20(a) with exculpatory language.

Because of the rapidly expanding volume of litigation charging violations of the federal securities acts and the propensity of the parties aggrieved thereby to seek to impose liability not only upon the offending party but also those who are deemed to "control" the offender, it is of utmost importance that this Court resolve this conflict between the Circuits as to the proper interpretation of Section 20(a). The significance of this issue and the conflict between the Circuits further justify the grant of certiorari to review the judgment below.

CONCLUSION.

For the above and foregoing reasons, a Writ of Certiorari should issue to review the judgment and opinion of the United States Court of Appeals for the Seventh Circuit.

Respectfully submitted,

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August, 1972.

APPENDIX.

REPORT OF SPECIAL MASTER CHARLES A. BANE

IN RESPECT OF THE CLAIMS OF

OLGA HOCHFELDER, ET AL.,

FILED NOVEMBER 24, 1970.

IN THE DISTRICT COURT OF THE UNITED STATES
For the Northern District of Illinois
Eastern Division.

Securities and Exchange Commission,
Plaintiff,
vs.
First Securities Company of Chicago, a corporation,
Defendant.

Civil Action No. 68 C 1053.

REPORT OF THE COURT'S SPECIAL MASTER IN RESPECT OF CLAIMS OF OLGA HOCHFELDER, THERESA W. ROTHEL, AGNES SMITH, EUGENE VOITA, HELEN FELDKAMP, ANNA L. JESSE, WILLIAM P. JESSE, ERIC W. STUBBS, LURENA T. STUBBS, HELEN C. ALLISON, LEON N. CARNOVSKY, ZERAH A. RAKE, JOHN M. JACKSON, TRUSTEE, JOHN V. JACKSON, INDIVIDUALLY, AND ELIZABETH B. JACKSON ("THE ESCROW CLAIMANTS").[1]

[Filed November 24, 1970.]

Each of the fifteen escrow claimants had been a brokerage client of First Securities Company of Chicago, buying and selling stocks on which regular commissions were paid and with confirmations of the usual type for a brokerage firm being furnished. One day one of the claimants that he had obtained an opportunity for the claimant to make a favorable investment in an escrow

1. Incorporates corrections authorized by court order on Nov. 24, 1970.

which would yield a high rate of interest. He told the claimants, in his attempts to convince them to make the investment, that his wife, step-daughter and a number of close friends had invested in it. He explained the escrow as being a fund that was to be used by a small loan company (which he consistently did not name) which, according to Nay, could charge a high rate of interest under the law (up to 2½% a month) and could therefore afford to pay up to 1% a month (later reduced to 9% a year) for a portion of its funds. To fourteen of the fifteen claimants, Nay gave this advice in the offices of First Securities, although at no time did Nay tell the claimants that First Securities had anything to do with the escrow, or that it had any interest or participation therein, or that he was acting on behalf of First Securities in obtaining funds. Usually Nay told the claimants not to talk about the escrow and to keep it very quiet.

In the usual instance, the funds invested by the claimants in the escrow were derived from the sale of stocks in a transaction effected through First Securities. The proceeds were then transmitted by First Securities to the claimants, and the claimants then drew their own checks, to represent the escrow investment, payable to Nay personally (or in a few instances, to a bank for his personal account). The checks were endorsed by Nay individually.

Nay employed numerous devices to convince the escrow investors that their investment was being handled in an orderly and businesslike fashion. For example, Nay informed them that if he was out of town on an interest date, "the bank" was instructed to send out the interest checks. Further, Nay gave the impression that money had to reach him by a certain day of the month by a certified check if it was to draw interest for that month. Nay often represented that funds which could be invested in the escrow

were limited and that when there was an "opening", Nay was allowed only a portion of the investment opportunity and that this portion he was sharing with the proposed investors. Hence he would present his offer to invest in the escrow as an "opportunity".

At Nay's death, the net amounts invested in the escrow by the various claimants were as follows:

Olga Hochfelder	$ 21,500
Theresa H. Rothermel	35,000
Agnes Smith	24,000
Eugene Voita	80,000
Helen Feldkamp	47,500
Anna L. Jesse	176,000
William Jesse	22,000
Eric Stubbs	129,500*
Lurena Stubbs	40,000
Helen Allison	96,000
Leon N. Carnovsky	65,000
Zerah A. Drake	10,000
John M. Jackson, Trustee	70,300
John M. Jackson, Individually	89,700
Elizabeth B. Jackson	66,000
	$972,500

Upon the making of the investment, receipt of the sum advanced was acknowledged and the terms of the arrangement were confirmed by Nay in a handwritten letter (on First Securities letterhead) signed by him as "Leston B. Nay", without any title or designation of position with First Securities (the letterhead itself did not carry his name or designation as "President"). This handwritten letter was mailed in a First Securities envelope, again with the name and address of the addressee handwritten.

In some instances, promissory notes were given to claim-

* By agreement of the counsel of the claimants and counsel of the Receiver, this amount was agreed upon in lieu of the original amount of $149,500.

ants, but in every case, they were the personal notes of Nay. In 1954 when Zerah Drake succeeded in withdrawing $30,000 of the escrow funds from Nay, Nay offered to give a note for the balance of $10,000; this offer was allowed to slip by.

Upon the making of the investment, the investor-claimant was paid interest at the promised rate by Leston Nay's personal checks, drawn on his personal bank account. Claimants regularly received from Nay, on an annual basis, Treasury forms 1099 showing the amount of interest paid to them by Nay during the preceding calendar year on the escrow funds. These forms showed that Nay was claiming a deduction for such interest payments on his personal Federal income tax returns.

During the years 1953 through 1967 (but excluding the year 1955 for which copies of the Treasury forms 1099 cannot be located in Nay's personal files), Nay paid the following total amounts of interest to the claimants on the escrow funds.

Olga Hochfelder	$ 11,236.31
Theresa W. Rothermel	75,976.00
Agnes Smith	33,265.23
Eugene Voita	100,444.72
Helen B. Feldkamp	63,166.76
Anna L. Jesse and William P. Jesse	124,447.89
Eric W. Stubbs and Lurena T. Stubbs	137,397.25
Helen C. Allison	8,019.10
Leon N. Carnovsky	5,747.56
Zerah A. Drake	17,752.91
John M. Jackson, Trustee	27,601.96
John M. Jackson, Individually, and Elizabeth B. Jackson	34,495.55
	$639,551.24

During the last several years prior to Nay's death, his interest payments to the claimants on the escrow funds became irregular and delinquent.

Nay's personal Federal income tax returns for the years 1956 and 1965 were audited by the Internal Revenue Service. In connection with each audit, Nay advised the escrow investors that his tax return was being examined and asked that they verify the amount of his indebtedness to them and the amount of the interest he had paid them during the year under review. These letters were accepted as correct by the claimants, signed by them and returned to Nay to indicate their concurrence in the statements. On their own income tax returns, claimants reported the interest received as income and showed Nay as the payor.

Nay's agreement with the escrow investors frequently contained the express provision that "This agreement is binding and inures to the benefit of your and my heirs, executors and assigns." Several of the claimants made inquiries of Nay as to how they should proceed in the event of his death. Nay told such inquiring claimants that they would be taken care of by the Continental Bank, where the escrow was maintained, or by his wife or his lawyer. Mr. Stubbs, testified that Nay told him that if Nay died the money "would be there in his estate and it would be easily reached". Nay wrote to Mrs. Drake, "If I die, file a claim against my estate with letters, receipts, etc." Other claimants were advised by Nay that since the funds were in escrow, the participants would be paid off "independently of the probating of my estate".

John M. Jackson regarded his advance as being a loan to Nay. In Jackson's Exhibit 24B, Jackson wrote to Nay, "Please reduce my loan to you from John M. Jackson, Trustee, u/w/o William H. Jackson, deceased, by $5,000, and increase my loan to you from John M. Jackson as an individual by a corresponding $5,000."

At the time of the death of Mrs. Rothermel's husband, his escrow balance of $31,000 was referred to as the "Note of Leston B. Nay" in the joint consent of the Illinois Attorney General and State Treasurer to its transfer to Mrs. Rothermel.

Mrs. Feldkamp inquired of Nay by letter, "Is the escrow fund managed through First Securities Company of Chicago, or by you as an individual?" (Feldkamp Exhibit 35). In response Nay informed Mrs. Feldkamp by telephone that the escrow participants had invested funds with him as an individual. Mrs. Feldkamp made no objections. Professor Carnovsky referred to Nay's escrow obligations as Nay's "various demand notes."*

The paper work in connection with the escrow funds bore no resemblance to the procedures followed by Nay and the claimants when a transaction was carried out through First Securities. When the claimants paid for stocks that they purchased through First Securities, they made their checks payable to the order of First Securities, not to Nay. When they had money coming from the sale of securities they received checks from the company, not Nay's personal checks. Whenever the claimants had delivered funds to First Securities in connection with their securities transactions (as distinguished from the escrow) they received regular, printed receipt forms expressly signed on behalf of First Securities. Whenever First Securities made a collection for a claimant of interest, dividends or the proceeds of a Treasury bond, the claimant would receive a regular printed form used by First Securities for that purpose.

* Since the claimants herein are individuals, and are treated as a group only because of common questions of law and fact, the Special Master does not regard the admission of any one claimant as binding the others. Hence, the admissions of Mr. Jackson, Mrs. Rothermel, Mrs. Feldkamp and Professor Carnovsky are binding only on each of them individually. But they do show a pattern in the manner in which the escrow investments were handled by Nay.

Statements of accounts received by the escrow claimants from First Securities never included any reference to the escrow transactions or the interest payments on the escrow investments.

Throughout the history of the escrow, prior to Nay's death, the escrow was unheard of by other employees of First Securities. All papers relating to the escrow were found on Nay's death under lock and key in his private office in places where other employees had no access. Nay's personal checking account and his income tax return which contained information relating to the escrow were handled by him exclusively and similarly were under lock and key. No one else in the office was permitted to open mail addressed to Nay or to his attention.

There were a few actions either on the part of claimants or of Nay himself, which related First Securities to the escrow operations, in addition to the circumstance that the original receipts and statement of terms, though handwritten, were on First Securities letterhead and mailed in a First Securities envelope. Interest checks sent by Nay, although drawn on his personal account, were sent in First Securities envelopes. Nay told Mrs. Jesse that the escrow opportunity arose because Nay, "through First Securities", had done a favor to a small investment company. Similar representations were made to Mr. Jackson, who, in forwarding his initial investment to Nay, addressed his letter to "Mr. Leston B. Nay, President, First Securities Co. of Chicago." When Mrs. Rothermel put funds into the escrow, she drew the check to the order of Leston B. Nay but sent it to First Securities in care of Nay.

Nay told Mr. Stubbs that the escrow was a "secret between his company and the finance corporation." Mrs. Allison testified that Nay was "my man at First Securities." Mr. Carnovsky was told by Nay when Carnovsky

wanted to withdraw a part of his escrow investment that Carnovsky had nothing to worry about and that "his money was safe at First Securities." Nay told the Voitas that "he and his company" had a financial arrangement with a loan company. Nay stated to Mrs. Stubbs that she had a better investment than Sears stock, through First Securities, in the escrow.

A number of the claimants were close to Nay personally. Mrs. Jackson testified that in her household the name Nay "was a household word". Six of the claimants had named Nay executor or co-executor in their wills.

In June, 1968 when Nay committed suicide, he left a note admitting that the escrows were "spurious". That was the first time that any of the claimants knew that they had been deceived.

The question under all of the foregoing circumstances is whether First Securities can be held liable for the activities of Leston B. Nay in respect of the spurious escrow. The question is basically one of agency law, and specifically whether the relationship of principal and agent can be found, with respect to the escrow transactions, between First Securities and Nay, with Nay having either actual or apparent authority from First Securities to do the things he did.

There is no question that Nay had no actual authority to act for First Securities with reference to the escrow transactions. Nothing in the record shows any action by First Securities to authorize Nay to carry out the escrow transactions and it cannot be maintained that Nay had such actual authority by reason of his position as president and principal shareholder of First Securities.

The claimants have argued, however, that there was apparent authority in Nay and cite as authority Sections 261

and 262 of the American Law Institute Restatement of the Law of Agency. Sections 261 and 262 read as follows:

Section 261:

> "A principal who puts a servant or other agent in a position which enables the agent, while apparently acting within his authority, to commit a fraud upon third persons is subject to liability to such third persons for the fraud."

Section 262:

> "A person who otherwise would be liable to another for the misrepresentations of one apparently acting for him is not relieved from liability by the fact that the servant or other agent acts entirely for his own purposes, unless the other has notice of this."

One of the illustrations given in the Restatement under Section 262 is this:

> "1. P, whose business is that of advising persons concerning investments, represents to T that A is his manager. At P's office, T seeks advice of A concerning investments. A, acting solely to promote an enterprise of which he is the owner, made deceitful statements in regard to it, on the strength of which T invests and loses. P is subject to liability to T."

This illustration from the Restatement is cited in *Blackburn* v. *Witter*, 1962, 19 Cal. Rptr. 843. A widow without business experience went to the brokerage office of Dean Witter and Co. and selected an employee, Mr. Long, as her investment adviser. Once a month he suggested stocks for her to buy and sell. She acted in accordance with his suggestions. He persuaded her to invest in a nonexistent company on the plea that he could get from it a higher rate of return than she was getting from her stocks. She obtained the money to invest by selling some of her stocks through Long acting as agent for his employer. He gave

her for her money "Rediform" receipts, which he later supplemented by his own promissory notes bearing 10% interest. She admitted that she received each month a transaction sheet from the broker setting forth all transactions between her and the brokerage house for the preceding month. None of the transactions between her and Long concerning the non-existent company appeared on any of these monthly reports. The brokerage firm contended that the widow must have known, or should have known, that Long, when he took her money for investment, was acting for himself and not on behalf of the brokerage house. This argument was not sustained, and a judgment against the broker was affirmed on the basis of the ostensible authority of Long to act for the broker, citing Sections 261 and 262 of the Restatement of the Law of Agency. The Court said that Dean Witter & Co. could not "concede that the part of the transaction by which respondents sold her stock through Long and the brokerage house to obtain the money was within the scope of Long's agency, while the part of the transaction whereby Long received the proceeds of the stock sale was not within the scope of his apparent authority. In short, it is difficult to see how appellants can accept the benefits of the sale of the stock by Long as their agent and deny liability for the fraudulent misuse of the money obtained by the sale of the stock." (p. 845.)

It is clear, however, that in *Blackburn* v. *Witter*, not only did the broker hold Long out as its agent but the agent represented to the customer that he was acting for his employer. It seems to be established law in Illinois (as elsewhere) that an essential element of the doctrine of apparent authority is that the agent must purport to act in the particular transaction in behalf of the principal. In the recent case of *Lawcock* v. *United States Trotting Ass'n.*, 55 Ill. App. 2d 211, 216-217 (1965), the court said:

"Apparent authority 'to do an act is created as to a third person by written or spoken words or any other conduct of the principal which, reasonably interpreted, causes the third person to believe that the principal consents to have the act done on his behalf *by the person purporting to act for him*' (Restatement of Agency 2d § 27, P. 103.)" (Emphasis supplied.)

This position has been previously recognized by the Special Master and by the Court in the former's recommendation and the latter's ruling in respect of the *Moyer* claim. The Special Master's memorandum on *Moyer* stated that the root question was "whether the transactions purported to have been carried out, on the broker's side, by Mr. Nay individually or by him on behalf of First Securities."

Judge Hoffman in his opinion approving the Special Master's recommendation stated:

". . . As the court has previously remarked with regard to the claim arising out of the securities, there are two questions involved in determining such liability,—Mrs. Moyer's understanding of the transaction being only one of them. The other question is that of tangible proof of company involvement.

"Mrs. Moyer may or may not have believed that Nay would pass her money on to whomever bought bonds and things at the company, but, in either event, she sent her check to Nay drawn to his order and did not receive a receipt identified as that of First Securities for it as she had for her securities. This was, therefore, a personal transaction. The fact that she received a cancelled check back does not tend to prove the contrary. The check was endorsed personally by Nay alone.

"For these reasons, I concur with the judgment of the Special Master and disallow this final portion of the claim". (Tr. 4-30-69, pp. 16-17.)

The Special Master finds here that Nay did not purport to act for First Securities in connection with the escrow transactions; he never told any of the claimants that he was so acting; all funds were given to him by checks made payable to him personally; all interest was paid by his personal checks; and by many different forms of written communications (such as U. S. Treasury Forms 1099, letters confirming the sums due to the claimants and the interest paid thereon for income tax audit purposes, and other documents and letters); it was clear that the escrow transactions involved Nay's personal actions rather than those of First Securities.

The circumstances under which the name of First Securities came into the escrow arrangements, such as Nay's representations that these opportunities arose because he, as president of First Securities, had done a favor for a small loan company, do not reach the level of representations by Nay that he was acting for First Securities in the escrow transactions. Nor can such representations be derived from the use by Nay of First Securities letterhead and envelopes for his handwritten notes and transmittal of personal checks for interest. In view of the widespread use of business or professional stationery by business and professional people for personal purposes, it certainly cannot be a valid rule of law that a principal or employer is bound by reason of such use alone.

The Special Master, therefore, recommends that the Court find that Leston B. Nay had no authority, actual or apparent, to act for First Securities in the escrow transactions and that accordingly First Securities is not liable for any losses resulting to the claimants from such transactions.

The parties in their briefs before the Special Master have argued the question of diligence. Counsel for the Receiver

has urged that even if Nay could be found to have purported to act as agent for First Securities, the claimants must use reasonable diligence and prudence to determine whether Nay was acting within the scope of his authority. In view of the Special Master's recommendation that the Court find that Nay ought not to be considered as having purported to act as an agent for First Securities, it is unnecessary to pass on the point of diligence.

The parties have also argued, in connection with the admissibility of conversations between the claimants and Nay, whether the Illinois Dead Man's Statute should apply to exclude such conversations. Chapter 51, Section 4, Illinois Revised Statutes, provides in pertinent part as follows:

> "... and in every action, suit or proceeding a party to the same who has contracted with an agent of the adverse party—the agent having since died—shall not be a competent witness as to any admission or conversation between himself and such agent, unless such admission or conversation with the said deceased agent was had or made in the presence of a surviving agent or agents of such adverse party, ..."

Although there had been criticism in recent years of the Dead Man's Rule and the preliminary draft of *Proposed Rules of Evidence for the United States District Courts and Magistrates* would abolish the Dead Man's rule under such circumstances as are present here, there is no doubt that in this Circuit, the federal courts have been required to follow the Illinois statute: *Hill* v. *A. J. Canfield Co.*, 157 F. 2d 849 (7th Cir. 1946). However, in the instant proceeding, there is some question whether the Dead Man's Statute should be applied since the statute requires, by its terms, that the deceased whose conversations are to be excluded be found to be an agent, whereas counsel for the Receiver and others opposing the claimants argue that there was no such agency.

The Special Master admitted the testimony subject to later rulings. The Special Master here states that such testimony did not play a substantial part in his conclusions and was not the balancing factor in determining the invalidity of the escrow claims against First Securities. The Special Master recommends that the objected to testimony be allowed to stand for informational purposes only and that the Court not base its conclusions as to whether or not to affirm the Special Master's recommendations upon such testimony in whole or in part.

In view of all the foregoing, the Special Master recommends that the Court hold that the claims of the escrow claimants, in the amounts set forth on page 3 hereof, be denied in their entirety as claims against First Securities Company of Chicago.

/s/ Charles A. Bane,
Special Master.

November 10, 1970.

OPINION OF UNITED STATES DISTRICT JUDGE

JULIUS J. HOFFMAN

DELIVERED DECEMBER 18, 1970.

IN THE DISTRICT COURT OF THE UNITED STATES.

• • (Caption—68-C-1053) • •

OPINION.

Judge Hoffman: This matter, as has been indicated here, involves claims asserted against the First Securities Company of Chicago in the aggregate amount of $972,500 based upon moneys which were deposited by the fifteen claimants in a so-called escrow fund created by the late Leston B. Nay. The fifteen claimants are Olga Hochfelder, Theresa W. Rothermel, Agnes Smith, Eugene Voita, Helen B. Feldkamp, Anna L. Jesse, William P. Jesse, Eric W. Stubbs, Lurena T. Stubbs, Helen C. Allison, Leon N. Carnovsky, Zerah A. Drake, John M. Jackson, Trustee, John M. Jackson, individually, and Elizabeth B. Jackson.

During the course of the proceedings both before the Special Master and here, these fifteen claimants have been referred to as the escrow claimants. Each of these escrow claimants was a brokerage client of First Securities Company of Chicago of which the late Leston B. Nay was president and controlling stockholder.

The claims asserted against First Securities arise out of a spurious escrow fund that was created by Nay. Nay told each of the claimants of an opportunity to invest in an escrow fund which would yield a high rate of interest. To persuade the claimants to invest in the fund, Nay said that members of his family and a number of his close friends had invested in it. The claimants were told that the fund would pay a rate of interest up to one percent per month which was later reduced to 9 percent per year for a portion of its funds.

The investors in the fund were told that the fund must be

kept secret and that they should therefore not talk to others about it.

In most instances the funds invested in the escrow were obtained by the claimants through the sale of securities held by them. Those transactions were effected through First Securities. After the claimants had sold their stock, they drew their own checks for investment in the escrow and made them payable to Nay personally or to a bank for Nay's personal account.

Nay advised fourteen of the fifteen claimants to invest in the escrow fund while they were in the offices of First Securities, although Nay did not tell any of them that First Securities was managing or participating in the fund or that he was acting in behalf of First Securities in obtaining funds.

After Nay's death, the spurious nature of the escrow fund was discovered.

To recover the amounts of their investments, the investors in the escrow fund have filed their claims against the receiver of First Securities. The fifteen claims were consolidated for hearing before the court's Special Master because they presented common questions of law and fact.

The theory advanced by the claimants before the Special Master is that in obtaining funds from the claimants for investment in the escrow fund, Nay was acting with apparent authority as the agent of First Securities. It is the contention of the claimants that Nay purported to act for First Securities and is therefore liable for the claimants' loss.

After hearing testimony and reviewing numerous documentary exhibits, the Special Master found that with respect to the escrow fund scheme, Nay did not purport to act on behalf of First Securities and had no apparent authority to do so and that First Securities should not be held liable

as Nay's principal. The Master therefore recommended that the claims of the fifteen escrow claimants be denied in their entirety as claims against First Securities.

Rule 53(c)(2) of the Federal Rules of Civil Procedure provides, among other things, as follows:

> "In an action to be tried without a jury, the court shall accept the master's findings of fact unless clearly erroneous."

Unless clearly erroneous, the special master's findings are binding on the district court. In re Vernon Hills, Incorporated, 348 F. 2d 4, 7th Circuit, 1965.

Having reviewed the transcript of testimony before the Special Master and the exhibits introduced by the respective parties, and now having heard oral arguments by counsel, I have concluded that the findings of the Special Master are not only not clearly erroneous but that they are clearly correct.

Under Illinois law, he who asserts the existence of an agency has the burden of proving that fact. Nelson Development Company v. Ohio Oil Company, 45 Fed. Supp. 933, Eastern District of Illinois, 1942; Stone v. Stone, 407 Ill. 66, 1950.

There is no claim here that Nay had actual authority to act in behalf of First Securities in obtaining funds for the spurious escrow fund.

For one to be held to have had apparent authority to act as an agent, the alleged agent must have purported to act on behalf of the alleged principal. Quoting the Restatement of Agency 2d, Section 27, the court in Lawcock vs. United States Trotting Association, 55 Ill. App. 2nd 211 stated—and I am mindful of counsel's deprecating comment about the Illinois Appellate Court; nevertheless it is a highly respected court:

> "Apparent authority 'to do an act is created as to a third person by conduct of the principal which, reasonably interpreted, causes the third person to believe that the principal consents to have the act done on his behalf by the person purporting to act for him.' 55 Ill. App. 2nd at 216. See also Alterman v. Lydick, 241 F. 2d 50, 7th Circuit, 1950."

The case relied upon by the claimants, Blackburn v. Witter, 19 California Reporter 842, 1962, is not contrary to that proposition. In Blackburn the court held the broker liable for its agent's misuse of money obtained by the sale of stock. In that case, however, it was clear that the agent represented to the injured customer that he was acting for his employer. In the case at bar the Special Master found that Nay lacked apparent authority to act as the agent of First Securities because the evidence established that Nay did not purport to be acting in behalf of the company with respect to the escrow fund. That conclusion is amply supported by the circumstances surrounding the escrow fund transactions. The evidence shows that at no time did Nay specifically tell any of the claimants that he was acting on behalf of First Securities in obtaining funds for the escrow or that First Securities was involved with the management of the fund. Rather, the facts establish that the escrow fund investors dealt with Nay personally and that he acted in an individual capacity. When the claimants invested in the fund, they made their checks payable to Nay personally or in some cases to a bank for Nay's personal account and the checks were endorsed by Nay individually, not as agent or officer of First Securities. All funds that were withdrawn from the escrow fund were paid to the claimants by checks drawn by Nay on his own personal bank account. In addition, the claimants regularly received Treasury Forms 1099 showing the amount of interest paid to them by Nay for each calendar

year indicating that Nay deducted such interest payments on his individual federal income tax returns. In two years, 1956 and 1965, Nay's tax returns were audited by the government. In connection with these audits, Nay obtained from the claimants letters verifying the amount of his indebtedness to them and the amount of interest he had paid during the years under review. Those letters show that the claimants knew that the escrow gave rise to a personal indebtedness that was Nay's individually. These facts concerning the escrow arrangement are particularly significant in establishing that Nay acted individually and did not purport to act for First Securities when compared with transactions that were carried out between the claimants and the company. When the claimants purchased stocks through First Securities, they made their checks payable to the company, not to Nay, and when they received money from First Securities for stocks sold through it, the checks were drawn on the company's account, not on Nay's personal account. When the claimants delivered securities or funds to First Securities in connection with securities transactions, they received printed receipt forms signed on behalf of the company. When First Securities made collections for claimants of interest, dividends or proceeds on bonds, the claimants received a regular printed form used by the company for that purpose. And those claimants who received statements of their accounts with First Securities observed that the statements did not include the escrow fund or the interest payments thereon.

All of these factors concerning the manner in which the escrow fund transactions were carried out in contrast with other business between the claimants and First Securities establish that Nay did not purport to act on behalf of the company and could not reasonably have been thought to do so.

The only significant fact which the claimants cite that lends any credence to their view that Nay purported to act in behalf of First Securities is that some of the correspondence from Nay to the claimants was written on First Securities' letterhead and was mailed in First Securities envelopes. While this fact may not be without relevance, it is not entitled to great weight since it is not uncommon for business or professional people to write personal letters on office stationery. I do it every day.

During the course of the hearings before the Special Master, some testimony concerning statements made by Nay was objected to on the ground that it is inadmissible under the Illinois dead man's statute, Illinois Revised Statutes, Chapter 51, Section 4. The Master received the testimony subject to later ruling on the objections, observing that there is some doubt as to the applicability of the statute to this case.

I have concluded that it is unnecessary to determine the applicability of the statute to the evidence received by the Master because that evidence has not been significant in my determination of the issues presented. Neither my nor the Master's conclusions were based upon testimony objected to. On the other hand, none of the evidence in dispute, if admissible, would be sufficient to alter my disposition of this case.

The parties also argued before the Special Master the question of the claimants' diligence to determine whether Nay had actual authority to act on behalf of First Securities in the escrow transaction. I concur with the Master that it is unnecessary to rule on this issue in view of my ruling that Nay had no apparent authority to act for First Securities.

The claimants have also argued that First Securities should be held liable for the violation of Securities and

Exchange Commission Rule 10b-5 promulgated pursuant to Section 10(b) of the Securities and Exchange Act of 1934, 15 U. S. C. § 78(j).

The finding that Nay acted individually and not as agent for First Securities, however, precludes imposition against the company as the wrongdoer's principal. See Ross v. Licht, 263 Fed. Supp. 395, Southern District of New York, 1967; Carr v. Warner, 137 Fed. Supp. 611, District of Massachusetts, 1955; Nash v. J. Arthur Warner & Company, 137 Fed. Supp. 615, District of Massachusetts, 1955.

The claimants have cited a number of cases which are inapposite to the situation here. There is no evidence to support a finding that First Securities knew or had reasonable cause to know that Nay was carrying out his transactions with respect to the escrow fund fraud. Nor is there any evidence to establish that First Securities was guilty of inadequate supervision of its agent. Nay's guilt in keeping a private record of the escrow transactions and not entering them on the company's books cannot be imputed to First Securities. Nor is the fact that the other employees of First Securities did not open mail addressed to Nay even remotely analogous to the situation in which securities dealers have been held liable under Rule 10b-5 for inadequate supervision.

Furthermore, I cannot agree with the claimants' view that First Securities may be held liable for Nay's fraud under Section 20(a) of the Securities and Exchange Act, 15 U. S. C. § 78. That section provides:

> "Every person who directly or indirectly controls any person liable under any provision of this chapter or any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling per-

son acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or causes of action."

Thus First Securities Company would be liable for the acts of its "controlled person" under Section 20(a) only if it acted in bad faith or induced the unlawful acts. There is not sufficient evidence that First Securities acted in bad faith with respect to the escrow funds, or that it directly or indirectly induced the fraud.

In view of the foregoing, I must conclude that First Securities is not liable for the acts of Leston B. Nay and that the claims of the escrow claimants should be denied.

OPINION OF THE UNITED STATES COURT OF APPEALS

FOR THE SEVENTH CIRCUIT

DELIVERED APRIL 12, 1972.

IN THE UNITED STATES COURT OF APPEALS.

* * (Caption—No. 71-1272) * *

Argued January 24, 1972—Decided April 12, 1972.

Before SWYGERT, *Chief Judge*, HASTINGS, *Senior Circuit Judge*, and SPRECHER, *Circuit Judge*.

SWYGERT, *Chief Judge*. This is an appeal from the disallowance of fifteen claims of individuals in the total amount of $972,500 asserted against the assets of a securities brokerage firm with regard to which an equitable receivership is in progress in the district court. The defendant in the equitable receivership, First Securities Company of Chicago (hereinafter, "First Securities"), was registered with the Securities and Exchange Commission as a broker-dealer in securities and was a member of the Midwest Stock Exchange and the National Association of Securities Dealers, Inc. On June 4, 1968, Leston B. Nay, President of First Securities and owner of 92 percent of its stock, murdered his wife and committed suicide, leaving a suicide note which described First Securities as being bankrupt because of his thefts and which described certain "escrows" which were his creation as "spurious." On June 10, 1968, the SEC initiated this receivership action against First Securities. The claims which are the subject matter of this appeal derive from Nay's creation of and dealings in a fraudulent escrow account. The district court appointed a special master to hear and determine the validity of these claims. In accordance with the recommendation and findings of the special master, the district court disallowed all of the instant claims in their entireties, and this appeal followed.

The special master specifically found most of the following facts to be established by the evidence, which findings

the district court approved. The remaining facts stated here are undisputed in the record. The fifteen claimants had each been brokerage clients of First Securities, buying and selling securities through First Securities in regular fashion. Each received investment advice from Nay, and each knew Nay to be the president of First Securities. Nay advised each of the claimants that he was able to offer to the claimant an opportunity to invest in a so-called escrow which would yield a high rate of interest (generally twelve percent per annum, but later reduced to nine percent). As to fourteen of the claimants he recommended investment in the escrow when the claimants were actually in the offices of First Securities. He explained that the escrow opportunity had come to him because he had done a favor for a small investment company through First Securities. Although Nay was always somewhat vague and secretive about the details of the escrow (he explained that the escrow was necessarily a "secret" between First Securities and an unnamed finance company), he described the escrow as being a fund which was to be used as the principal from which a small loan company would make loans. He further explained that the loan company could charge up to 2½ percent per month interest under the law, thus enabling the investors in the escrow to realize the high rates of interest promised. Typically, upon being persuaded by Nay that the escrow was the best possible investment for them, the claimants sold legitimate securities through First Securities for purposes of obtaining the necessary cash to invest in the escrow. First Securities effected the sales, collected its commissions and submitted the proceeds to the claimants, who then drew their personal checks payable to Nay or to a bank for his account. Subsequent transactions with regard to the escrow were not in the form usual to dealings between customers and First Securities, nor was the escrow reflected in periodic accountings by First Securities to the claimants.

Upon receipt of the cash investment from the claimants Nay usually executed a handwritten document which acknowledged such receipt and confirmed the terms of the arrangement. Sometimes Nay gave promissory notes to the claimants. All, or substantially all, of Nay's correspondence with the claimants was written on letterhead stationery of First Securities. Some of the letterhead stationery included the words, "Leston B. Nay, President," on the upper left hand portion thereof. All of the stationery bore the legend, "Member Midwest Stock Exchange," in addition to the firm's name and address. Although much of Nay's correspondence with regard to the escrow transactions was handwritten by him, a substantial portion was typed by his secretary at First Securities.

During the early years of Nay's fraudulent enterprise, the claimants were paid interest from time to time based upon their "investments" in the escrow. Such payments were made by Nay's personal check sent in an envelope upon which First Securities' name and address appeared in the upper left hand corner in the position normally occupied by the return address of the sender. The interest payments were erratic and delinquent during the later years of the operation of the scheme. During the period of 1953 through 1967, with the exception of 1955, Nay's files revealed that he sent Treasury forms 1099 to each of the claimants which showed that the distributions of interest to them had been reported as a deduction from his personal income tax return. The claimants reported the interest payments on their income tax returns in accordance with the forms 1099 received from Nay. In connection with Internal Revenue Service audits of Nay's personal federal income tax returns for 1956 and 1965, he sent form letters to each of the claimants asking that they verify the amount of his indebtedness to them and the amount of interest he had paid them during the

year in question. Each of the claimants returned the letters marked and signed to indicate their concurrence with the amounts shown thereon as received from Nay. Also, from time to time some of the claimants referred to their escrow investments in correspondence with Nay as being personal loans to him.

As to some of the claimants, Nay's receipt for investments in the escrow took the form of a purported agreement or promissory note from Nay to the claimant which recited, "This agreement is binding and inures to the benefit of your and my heirs, executors and assigns." Upon direct inquiries from several claimants, Nay vaguely indicated that the escrow would be settled in the event of his death either by the bank which was supposed to be the locus of the escrow account, or by his wife or his lawyer. He told one claimant that in such event a claim should be filed against his estate. On the other hand, he advised some that since the funds were in escrow they would be handled outside the probating of his estate. He also told one claimant who was seeking to withdraw some of his investment from the escrow that his money "was safe at First Securities." By the same token, Nay from time to time had successfully dissuaded claimants from withdrawing money from the escrow to invest in other things.

Finally, it is clear that Nay had no actual authority to act for First Securities with regard to the escrow account. It is also clear that First Securities' employees (other than Nay) knew nothing of the nature of the escrow nor, except for his secretary, even of its existence. Nay had forbidden anyone other than himself to open mail addressed to him, and in his absence all such mail was simply allowed to pile up on his desk, even if it was addressed to First Securities for his attention.

The claimants assert that the foregoing facts entitled them to recover from First Securities their losses due to

Nay's fraud. They urge the propriety of that result on two grounds: that Nay acted with apparent authority as the common law agent of First Securities and that Nay and First Securities violated or are liable for violations of Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5 of the Securities and Exchange Commission and Rule 27 of the Rules of Fair Practice of the National Association of Securities Dealers, Inc. The special master and the district court rejected claimants' view on both theories and dismissed the claims. We reverse.

I.

Claimants' assertion that First Securities is liable as his principal for Nay's fraud is based in part on sections 261 and 262 of the Restatement of Agency, Second (1958). Section 261 states:

> A principal who puts a servant or other agent in a position which enables the agent, while apparently acting within his authority, to commit a fraud upon third persons is subject to liability to such third persons for the fraud.

Section 262 provides:

> A person who otherwise would be liable to another for the misrepresentation of one apparently acting for him is not relieved from liability by the fact that the servant or other agent acts entirely for his own purposes, unless the other has notice of this.

Example one of the illustrations given under section 262 is as follows:

> P, whose business is that of advising persons concerning investments, represents to T that A is his manager. At P's office T seeks advice of A concerning investments. A, acting solely to promote an enterprise

of which he is the owner, made deceitful statements in regard to it, on the strength of which T invests and loses. P is subject to liability to T.

Claimants also cite *Blackburn* v. *Witter,* 201 Cal. App. 2d 518, 19 Cal. Rptr. 842 (1962). The *Blackburn* case was also concerned with the liability of a broker-principal for the defrauding of a customer by its salesman-employee. The customer in *Blackburn* was a widow without business experience who had regularly been given investment advice by one Long, an employee of Dean Witter & Co. Long persuaded the customer to sell some of her regular securities through him as agent for Dean Witter & Co. and to invest the proceeds of the sale in a nonexistent company which he said would produce a higher return than usual. Long gave the customer receipts which were different from those used by his employer, later supplemented by his personal promissory notes bearing ten percent interest. The customer admitted that the transactions with Long were never reflected in periodic summaries of her transactions with Dean Witter & Co. submitted to her by that firm. The court there rejected the employer's argument that the widow knew or should have known that the transactions involving Long and the nonexistent company were personal to Long and not a part of his agency for his employer and held Dean Witter & Co. liable, citing Sections 261 and 262 of the Restatement. The crux of the court's decision was its conclusion that Dean Witter & Co. could not treat the portion of the transaction by which Long sold the widow's stock at her request as being within the scope of his agency and, at the same time, expect to prevail on its argument that the purchase of the fraudulent stock by Long with the proceeds of the sale was Long's personal act outside the agency relationship. 201 Cal. App. 2d at ....., 19 Cal. Rptr. at 845.

The special master concluded that in the instant case Nay did not act with apparent authority from First Securities *vis-a-vis* the claimants. Since the facts upon which he based that conclusion were essentially those we have recited above, we have determined that his conclusion is clearly erroneous. The genesis of the special master's error is unclear, but apparently he believed that verbal representations by Nay that he was acting on behalf of of his principal, First Securities, were essential to liability. We believe that sections 261 and 262 of the Restatement, example 1 to section 262, and *Blackburn* v. *Witter, supra,* belie such a position. We hold that those authorities are clearly dispositive of the agency theory herein and that they compel the conclusion that claimants are entitled to recover from First Securities. There is no direct authority on point in the Illinois case law, but we are convinced that Illinois courts would not differ on this issue from the rule stated in the Restatement and the *Blackburn* case.

II.

Claimants also contend that they are entitled to assert their claims under the Securities Exchange Act of 1934 against First Securities on the ground that it is liable for Nay's fraud for one or more of the following reasons: (1) First Securities was a "controlling person" as to Nay within the intendment of section 20(a) of the Securities Exchange Act of 1934, 15 U. S. C. § 78t(a); (2) First Securities, at best, aided and abetted Nay in violating section 10(b) of the Securities Exchange Act of 1934, 15 U. S. C. § 78j(b), and Rule 10b-5 promulgated pursuant thereto, 17 C. F. R. § 240.10b-5; or (3) First Securities failed to satisfy its duty to supervise Nay pursuant to Rule 27 of the Rules of Fair Practice of the National Association of Securities Dealers, Inc.

It is clear that Nay's conduct violated the provisions of section 10(b) of the Securities Exchange Act of 1934 and its regulatory corollary, Rule 10b-5. Both proscribe the use of any means of interstate commerce or of facilities of national securities exchanges to defraud or deceive in connection with the purchase or sale of any security. The parties do not contest the fact of Nay's violation of section 10(b) and Rule 10b-5, for he clearly violated both of them. Defendant asserts, however, that Nay's fraud is not properly chargeable to First Securities. We disagree. We believe that First Securities is liable for Nay's fraud under the Securities Exchange Act on each of the three theories advanced by the claimants.

Section 20(a) of the Securities Exchange Act of 1934 provides as follows:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action. 15 U. S. C. § 78t(a).

Although the statute does not define what constitutes "control" for purposes of the foregoing, we have no doubt that Nay, being the employee of First Securities as its president, was "controlled" by First Securities within the intendment of section 20(a). *See Hawkins* v. *Merrill, Lynch, Pierce, Fenner & Beane,* 85 F. Supp. 104, 122-23 (W. D. Ark. 1949).

The special master ignored this argument of claimants based on section 20(a), but the district judge rejected it, saying merely:

> "... First Securities Company would be liable for the act of its 'controlled person' under Section 20(a) only if it acted in bad faith or induced the unlawful acts. There is not sufficient evidence that First Securities acted in bad faith with respect to the escrow funds, or that it directly or indirectly induced the fraud."

However, the district judge gravely misapprehended the operation of section 20(a). As the Eighth Circuit observed in *Myzel* v. *Fields*, 386 F. 2d 718, 738 (8th Cir. 1967), *cert. denied*, 390 U. S. 95 (1968): "The statute is remedial and is to be construed liberally. It has been interpreted as requiring only some indirect means of discipline or influence short of actual direction to hold a 'controlling person' liable." Indeed, it has been held that "to satisfy the requirement of good faith [in order for a controlling person to avoid liability thereby] it is necessary for the [controlling person] to show that some precautionary measures were taken to prevent the injury suffered," *Lorenz* v. *Watson*, 258 F. Supp. 724, 732 (E. D. Pa. 1966), and "that failure of the controlling person to maintain and diligently enforce a proper system of internal supervision and control constitutes participation in the misconduct and the violation will be deemed to have been committed, not only by the controlled person, but also by the controlling person who did not perform the duty to prevent it." *Hecht* v. *Harris, Upham & Co.*, 283 F. Supp. 417, 438 (N. D. Cal. 1968), *modified on other grounds*, 430 F. 2d 1202 (9th Cir. 1970). Given the fact that First Securities enforced the rule established by Nay that mail addressed to First Securities at its office marked for his attention was to be opened by no one but Nay, we believe the firm directly facilitated the prolonging of the fraud, if not its very inception. We hold that First Securities was a controlling person of Nay and failed to act in good faith as those terms are used in section 20(a).

Claimants also assert that First Securities is liable for Nay's fraud as his aider and abetter without regard to whether it was a controlling person as to him. It is clear that one who aids and abets a violation of section 10 of the Securities Exchange Act of 1934 and Rule 10b-5 may be held civilly liable to one who is injured thereby. *Brennan* v. *Midwestern United Life Ins. Co.*, 417 F. 2d 147 (7th Cir. 1969); *Buttrey* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F. 2d 135 (7th Cir. 1969); *Anderson* v. *Francis I. DuPont & Co.*, 291 F. Supp. 705 (D. Minn. 1968); *Hawkins* v. *Merrill, Lynch, Pierce, Fenner & Beane, supra.* Moreover, liability predicated on aiding and abetting may be founded on less than actual knowledge and participation in the activity proscribed by section 10 and Rule 10b-5. *Buttrey* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc., supra* at 144.

In the *Buttrey* case we held that a broker-dealer would be liable as an aider and abetter to violations of section 10 and Rule 10b-5 committed by a *customer* of the brokerage firm. The act of the brokerage firm which provided a foundation for such vicarious liability was allowing the customer to trade in securities through a cash account in spite of his known financial instability and "erratic trading practices." In the *Brennan* case we held that an issuer of stock was liable as an aider and abetter to similar violations committed by a dealer in the stock on the ground that the president and general counsel of the issuer knew or should have known that the dealer was defrauding purchasers of the issuer's stock. We believe that the instant case presents a far more compelling case for the imposition of liability as an aider and abetter than either *Buttrey* or *Brennan.* Here, First Securities made Nay its president, provided him with the trappings of a successful investment counsellor, held him out as providing such counsel, and then wilfully allowed Nay's enforcement of a rule regarding the opening of mail which was antithetical to the prevention of

frauds of the type which occurred. We hold that First Securities aided and abetted Nay's fraud and is jointly liable therefor.

Finally, claimants urge us that First Securities failed to comply with Rule 27 of the Rules of Fair Practice of the National Association of Securities Dealers, Inc., of which it was a member. The rules of the N. A. S. D. were promulgated pursuant to section 15A of the Securities Exchange Act of 1934, 15 U. S. C. § 78o-3. Rule 27 provides in pertinent part as follows:

> (a) Each member shall establish, maintain and enforce written procedures which will enable it to supervise properly the activities of each registered representative and associated person to assure compliance with applicable securities laws, rules, regulations and statements of policy promulgated thereunder and with the rules of this Association.
>
> (b) Final responsibility for proper supervision shall rest with the member. . . .
>
> (c) Each member shall be responsible for keeping and preserving appropriate records for carrying out the member's supervisory procedures. Each member shall review and endorse in writing, on an internal record, all transactions and all correspondence of its registered representatives pertaining to the solicitation or execution of any securities transaction.

We have no doubt that the enforcement of Nay's rule regarding the opening of mail is sufficient without more to constitute a violation of Rule 27. Such violations provide a basis for private damage actions where the rule violated serves to protect the public. *Avern Trust* v. *Clarke*, 415 F. 2d 1238, 1242 (7th Cir. 1969); *Buttrey* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc., supra* at 142-43. First Securities is properly liable for Nay's fraud because of its violation of Rule 27 of the N. A. S. D.

The judgment of the district court is reversed.

ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT DENYING PETITION FOR REHEARING ENTERED MAY 31, 1972.

UNITED STATES COURT OF APPEALS

For the Seventh Circuit

Chicago, Illinois 60604

May 31, 1972

Before

Hon. LUTHER M. SWYGERT, *Chief Judge*

Hon. JOHN S. HASTINGS, *Senior Circuit Judge*

Hon. ROBERT A. SPRECHER, *Circuit Judge*

SECURITIES & EXCHANGE COMMISSION,
Plaintiff,
vs.
FIRST SECURITIES CO. OF CHICAGO,
Defendant.

OLGA HOCHFELDER, ET AL.,
Claimants-Appellants.

KEITH B. McKY,
Receiver-Appellee.

No. 71-1272

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division.

On consideration of the petition for rehearing and suggestion that it be heard en banc filed in the above entitled cause by Keith B. McKy, Receiver-Appellee, no judge in regular active service having requested a vote thereon, nor any judge voted to grant the suggestion, and the panel having voted to deny a rehearing,

IT IS ORDERED that the petition for a rehearing in the above entitled cause be and the same is hereby denied.

Section 20(a) of the Securities Exchange Act of 1934, 15 U. S. C. § 78t(a), as amended, reads as follows:

§ 78t. Liabilities of controlling persons

(a) Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.